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SENSITIVE
SIPDIS

DEPARTMENT FOR EUR/CE, INR/EC, TREASURY FOR ERIC MEYER,
JEFF BAKER, LARRY NORTON

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TAGS: EFIN ECON EU HU
SUBJECT: FUND INDUSTRY SURVIVING ECONOMIC CRISIS, BUT MAY
FACE DEATH BY EURO

REF: BUDAPEST 477

¶1. (SBU) Summary. 2008 was the worst year on record for the Hungarian investment fund industry, with capital flight and declining yields resulting in a decrease in total assets of Hungarian funds of over 20 percent. Real estate and money market funds were particularly hard hit. A run on Hungarian real estate funds beginning in October 2008 resulted in the Hungarian Financial Supervisory Authority suspending real estate fund redemptions for 10 days, and subsequently requiring several funds to restructure into close-ended funds. Although capital flight has slowed and the industry is fairly optimistic about attracting new capital, Hungarian funds continue to compete with banks offering high short-term interest rates. A major concern for the fund industry is Hungary's adoption of the Euro and the continued integration of the European fund market. Domestic fund companies fear that once Hungary adopts the Euro, there will be little to differentiate them from larger European fund companies, and local providers will devolve into sales offices for pan-European funds. Seeing the writing on the wall, fund industry executives hope that Budapest can become a "regional hub" for fund activity, and are urging the government to be forward looking in developing a new Investment Fund Act that could help attract regional fund management or back-office operations. End summary.

2008: WORST YEAR ON RECORD

¶2. (U) 2008 was the worst year on record for the Hungarian investment fund industry, resulting in a one-year decrease in total assets of Hungarian funds of over 20 percent (approximately HUF 563 billion, or USD 3 billion), with real estate and money market funds particularly hard hit. All categories of open-ended publicly offered funds investing in securities suffered huge redemptions, resulting in a decline of assets for all fund categories except for guaranteed funds.

¶3. (U) Although negative fund performance and increased volatility caused investors to begin withdrawing from investment funds early in 2008, an unprecedented wave of withdrawals came in late October after the GOH introduced guarantees for bank deposits, and the National Bank's 300 basis point increase in the base rate caused bank deposit rates to shoot up. Real estate funds were particularly hard hit by the wave of redemptions, and despite the funds' large liquidity cushions, in November 2008, the Financial Supervisory Authority (HFSA) was forced to step in and suspend redemptions of real estate funds for 10 days and to lengthen the redemption period for funds from around 3 days to up to 90 days (reftel).

OUT OF THE FRYING PAN...

¶4. (U) In recent months, rising yields and improved market sentiment have slowed the pace of withdrawals from domestic funds. In June, an estimated HUF 20 billion (approximately USD 100 million) was withdrawn, bringing the total redemptions for the first half of 2009 to HUF 158 billion (approximately USD 800 million). Despite the continued high level of redemptions, Andras Temmel, Secretary General of the Association of Hungarian Investment Fund and Asset Management Companies (BAMOSZ) believes that "the worst is over" and that as the economic climate in Hungary continues to improve, investors will begin to return. He also notes that declining interest rates for bank deposits will continue to make investment funds more attractive for retail investors. He predicts the funds likely to recover most quickly include commodity-based, derivative, and institutional funds. Despite heavy losses to the Hungarian fund market, Temmel points out that Hungarian fund industry losses (including withdrawals and declining asset values) have been lower than the average fund market in the EU.

...AND INTO THE FIRE

¶5. (SBU) BAMOSZ is not particularly optimistic about the future of the Hungarian domestic fund market, however. BAMOSZ Analyst Miklos Farkas notes that the domestic fund industry survives today by being able to offer HUF denominated funds to the generally risk-averse Hungarian retail investor. (Biographical Note: Miklos Farkas is the son of Istvan Farkas, the recently resigned president of the Hungarian Financial Supervisory Authority - see reftel. End biographical note). Once Hungary adopts the Euro, and once

the EU investment fund market is more integrated, Farkas believes that there will be little left to differentiate Hungarian investment fund companies from larger European funds. As a result, pan-European funds may come to dominate the Hungarian market, leaving behind only a domestic sales office.

¶6. (SBU) Temmel believes that one way the Hungarian fund industry could survive these impending changes is for Hungary to become a "Central and Eastern European regional hub" for fund activity, possibly including fund management or back-office operations. To do so, however, BAMOSZ believes Hungary would need to further develop its legislation to make it an attractive location for investment fund and asset management companies. For example, according to BAMOSZ, Hungarian legislation should include provisions for fund types not currently available in Hungary, like umbrella funds, and should change fund distribution rules for fund companies to create a more flexible legal and regulatory environment. BAMOSZ has provided input to the Ministry of Finance on developing a new Investment Fund Act, and believes the current government and the Ministry of Finance understand the issues and support the domestic industry.

COMMENT

¶7. (SBU) Other than a favorable legal environment, it is unclear what Hungary's relatively small market (comprised of about 400 funds managing approximately USD 13 billion) has to offer as a regional hub for investment fund companies. With the Finance Ministry preoccupied with crisis management and preparation of the 2010 budget, it is unlikely that a new Investment Fund Act will be enacted in the near term. Although BAMOSZ may have grounds for concern about the impact of eurozone membership on the Hungarian fund industry, the several years (or more) until Hungary meets the conditions necessary to adopt the Euro may give the industry time to adjust its business model. End comment.
LEVINE